RESEARCH HIGHLIGHTS

December 2002 Socio-economic Series Issue 107

UNDERSTANDING THE RELATIVE UNDERDEVELOPMENT OF REITS IN CANADA

The research assesses apartment and non-apartment REITs (Real Estate Investment Trusts) in the Canadian and in the American context. The main objective of this examination is to identify barriers and opportunities impacting apartment REIT growth in Canada.

A framework is developed for understanding the relative underdevelopment of REITs in Canada when compared to the American REIT industry. This framework identifies the factors in the Canadian environment that have contributed to the Canadian industry currently being less developed than its U.S. counterpart. Further, a summary of the drivers of success for both apartment and non-apartment REITs in both Canada and the U.S. is presented, based on the study of the participants in both environments. The overall intent of these examinations is to suggest a list of options that could enable the Canadian REIT industry in general, and the Canadian apartment REIT industry specifically, to eventually mirror the success seen in the U.S.:

> A Real Estate Investment Trust is a security consisting of a managed pool of capital, units of which are traded on stock exchanges. Investors, also called "unit holders", have an undivided beneficial interest in the properties owned by the REIT. Investors purchase "units" and receive a right to a proportional income stream resulting from the properties owned by the REIT. At regular intervals, usually monthly, investors receive "distributions". These distributions are the rents collected by the REIT, passed along to the investor. At the time when the investor sells his or her units, if the value of the units has increased in the market, the investor also receives a capital gain equal to the value between the sale price and the original purchase price of the units. REITs should not be confused with debt instruments.

The benefit of these vehicles to Canadian investors is that any income earned on the properties that is distributed to unit holders is deducted from the REIT-level tax bill. Instead of receiving its tax revenue on the rental income from the REIT directly, the government receives tax on the distribution from the unit holder who is taxed on the taxable portion of the distributions at his or her personal marginal rate.

An appeal of a REIT instrument to investors is the regular income it provides. When allocating investment dollars to fixed-income securities, the ability to shelter a portion of the income produced from the ownership of these instruments, coupled with any additional deductions allowable by the applicable tax code, is a major reason REITs have become attractive to investors. Alternative fixed income investments (e.g. dividends, bonds, mutual funds) do not allow the investor to shield income from taxation unless the investments are held within Registered Savings Plans. Coupled with traditionally higher yields than enjoyed by bonds, REITs have become an attractive alternative for investors in the fixed income market.

It is important to note that some of the tax benefits associated with REITs are immaterial to certain investors. Owning properties directly allows the investor access to the Capital Cost

CMHC SCHL
HOME TO CANADIANS
Canada

Allowance (CCA) flow through benefits in Canada or depreciation benefits in the United States, without the need for a REIT structure. Furthermore, assets held within a pension fund are already tax-deferred, so the tax treatment of REIT distributions would provide no incremental benefits to these investors. Nevertheless, there is a tax benefit for tax-exempt or tax-deferred entities electing to invest in REITs over real estate corporations, since the latter do pay tax at the corporate level.

Taxation of the REIT: In Canada, a REIT holding is established by a specific act by living persons, for the benefit of identified beneficiaries. As a result, it is subject to income tax at the top marginal tax rate for an individual on any taxable income that it earns. Consistent with the calculation of taxable income for real estate operations, and other business operations, a REIT is entitled to claim Capital Cost Allowance[1] (CCA) each year. While CCA reduces taxable income, it is, like accounting depreciation, a noncash expense. As a result, the cash flow of a REIT is generally higher than the REIT's taxable income. To the extent that the building is adequately maintained, the tax deduction afforded by the CCA is not related to any decline in value of the property. In fact, it is common for the real estate property to actually increase in economic value when at the same time the property is being slowly written off for income tax purposes. A critical difference in the computation of taxable income for a REIT compared to other structures for owning and operating real estate is that a REIT is permitted to deduct any income and capital gains that it distributes to the unit holders. As a result, REITs generally do not pay income tax because they transfer all of their taxable income to unit holders.

If the unit holder is a taxable entity, the distribution of income must be included in the unit holder's computation of taxable income. As a result, tax will be paid based on the marginal tax rate of the unit holder. Non-profit organizations, such as universities, etc., are non-taxable entities, and they would not pay any tax on these distributions. As a result, REITs have a potential tax advantage compared to corporations holding the same assets as the REIT, but have no notable advantage over non-profit organizations, pension funds and registered savings plans. If a corporation held the same assets that the REIT owns, it would be subject to tax at the corporate level on any income it earned. Therefore, any distribution of the corporation's after-tax flows to a non-taxable entity would have been subject to tax. This is because tax would have been deducted from the corporation's income before any distribution is made to the non-taxable entity. Stated another way, a corporation pays a dividend to its shareholders out of after-tax income. REITs do not have any tax deducted prior to distributing to the investor so these distributions do not face a direct or indirect tax burden.

Supply/Demand for REIT Offerings:

Given that there is limited capital available to be invested in the multitude of security offerings, increased demand for one security logically results in a corresponding decrease in demand for some or all other securities. The REIT industry is no exception to this dynamic. If REITs suddenly become less attractive relative to other investment offerings, the REIT industry is unlikely to continue to expand. Assuming that all relevant information is built into the yields (both from cash distributions and capital appreciation) earned on REIT offerings, it is possible to forecast future trends in REIT performance based on forecasts of pertinent information. For that reason, it is important to consider the factors that influence a REIT's performance (relative to other security offerings).

REITs, like bonds, have traditionally provided a nice hedge against declining equity markets. While the relationship is not exact, when equity markets decline, REITs tend to perform well. Hence, forecasts for equities will become extremely important for forecasting REIT capital appreciation (assuming distribution yields remain constant). As an economy enters a recession, equities become less attractive to investors, and the stock market tends to under-perform. On the other hand, as interest rates fall in a recession, traditional bonds, with a fixed return, become more attractive. REIT returns are locked in under lease contracts. When interest rates fall, this constant stream of REIT income becomes more attractive to investors.

However, one of the most positive aspects of a REIT is that although there is a tendency to perform well in equity market downturns, they also tend to fare well in equity market upturns. REITs do have the ability to adjust to increases in inflation by increasing rents over time. Compared to a bond with a fixed coupon, REITs are very attractive because their income stream is able to increase in an expansionary period. Because increasing inflation has

[1] Capital cost allowance is the tax equivalent of accounting depreciation. Under current rules buildings, including apartments, can be written off at four per cent declining balance. In the year of acquisition, the only one-half of the CCA may be claimed.

the effect of increasing interest rates, REIT distributions adjust to take into account higher inflation and interest rates, while bonds and mortgage backed securities (being long-term contracts) cannot adapt nearly as quickly. In heated interest rate environments, eventually growth in the equity markets tends to decline. REITs once again, become more attractive to investors. The only additional explanation for the spread of REITs yields over mortgage backed securities, appears to be a return for management-related risks and the possibility of loss of principal due to lack of asset maintenance.

Because of the REIT's ability to lock in returns, while retaining the flexibility necessary to increase income, regardless of the trend in the bond and equity markets, REITs tend to provide a stable source of return for investors.

Apartment and Non-Apartment REITs Compared, the U.S. Experience

Each specialized REIT category (hotel, office, retail, apartment, etc.) has its own specific risk profile. For instance, hotel REITs tend to prosper in times of economic growth and tend to face adversity in times of recession. Hotel REITs are extremely flexible in times of rising inflation because they are the most nimble class in their ability to adjust room rates, but are extremely vulnerable to decreases in individual disposable income. Office REITs fare well initially during downturns because they have the ability to lock-in rental rates over the long term. However, they are least able to adjust to periods of rising inflation. Retail and Office REITs tend to be rather illiquid because their properties are more difficult to sell, relative to other property types. Apartment buildings tend to be rather liquid and are easily bought and sold.

The U.S. apartment REIT has shown itself to be a particularly promising form of REIT specialization. These REITs tend to fare better than other REITs over the whole spectrum of economic conditions for a number of reasons. Apartment buildings tend to be far easier to sell than other property types. The cost of acquiring new tenants is lower for apartments than for other property types. Leasehold improvements are less costly for apartment tenants than for offices or retail complexes accommodating new tenants. Nevertheless, there exists some research that indicates apartment REITs in the U.S. tend to overpay for their properties, thereby reducing the return on investment to their unit holders.

The other major way in which apartment REITs tend to have an advantage over other REIT types is their ability to weather the business cycle comparatively unscathed. Apartment REITs tend to fare well in both economic downturns and expansions. During a downturn, many people who might have purchased a single-family home, owing to uncertainty in personal finances, instead opt to continue renting their residences. Interest rates also tend to fall during these periods, thereby reducing the debt-service cost to the REIT. During downturns, the higher yield of REITs, relative to bonds, attracts capital to the vehicles. REITs, in general, and apartment REITs, specifically, tend to provide a nice hedge against the equity market.

During times of economic expansion, apartment REITs, with their relatively short lease terms, are able to factor accelerated inflation rates into their rental rates more rapidly than other REIT categories. Rising interest rates, have not proven problematic for apartment REITs. The higher rates tend to discourage home purchasing on the part of tenants. Legislative and trust-declaration limits on the proportion of leverage a REIT may operate with, tend to keep debt-service requirements at a manageable level, even with rising interest rates.

Lending institutions tend to view apartment REITs more favorably than other REITs seeking debt financing. Because the value of the properties held by apartment REITs tends to stay high, reflecting their ability to generate consistent cash flow, these REITs have greater access to funding at better rates. It would appear as though apartment REITs have less difficulty meeting debt service requirements than other REITs, providing greater certainty of distributions for investors. Banks have little worry about apartment REITs being able to service their loans because the loss of an individual tenant does not have the same negative cash flow impact for an apartment REIT as for an Office REIT. Indeed, there has been some research indicating that apartment REITs have a tendency to carry higher levels of leverage (approximately 8 per cent more) than other REITs. This may allow a REIT more flexibility when attractive purchase opportunities arise.

Apartment REITs have begun to specialize along geographic or demographic lines. This allows the investor to further delineate his or her risk when making portfolio decisions. Many apartment REITs have chosen to concentrate on developing in areas of high growth and favorable demographics. The aging of the baby boomer generation promises to fuel further growth in apartment REITs as the burdens of home ownership encourage a shift towards apartment dwelling.

Apartment REITs have a number of positive aspects that make them an attractive investment for both those looking for fixed income alternatives, as well as for those seeking an hedge against negative economic impacts. Their superior funding opportunities (relative to those available to other REITs), coupled with their ability to

weather downturns in the business cycle, while also faring extremely well during upturns, make them an attractive investment choice for the investor:

U.S. Findings: Through discussions with research analysts working in both the U.S. and Canada, as well as discussions with, and research on the individual players in the U.S. REIT industry, a few general features of the U.S. REIT industry become very important in formulating Canadian options. The most critical findings include:

1. U.S. REIT holders view REITs as an alternative to equities. For the most part, U.S. REITs have elected to make use of a corporate structure. Hence, U.S. REIT investors are supportive of REIT management undertaking high levels of risk.
2. U.S. legislation is extremely REIT-friendly. As long as certain simple conditions are met, REITs have access to beneficial tax rules.
3. U.S. REITs operate in highly specialized niche market segments; they are large and diversify risk geographically. The geographic and demographic situation in the United States presents a multitude of profitable niche segments in which to specialize.
4. U.S. REITs have a much larger financial market from which to draw capital.
5. The U.S. financial markets are far more experienced and accepting of REITs as investment vehicles. The retail and institutional investor bases for REITs are approximately equal.

Canadian Findings: Discussions were held with Canadian analysts, institutional investors, and REIT operators. Certain features of Canadian REITs were identified that must be considered when suggesting changes to stimulate REIT growth in Canada.

1. Canadian REIT investors view REITs a alternative to bonds. Hence, investors in existing REITs are far less willing to permit REIT management to undertake development and other risks in the operation of their business. Indeed, an argument can be made that the Canadian Tax Code precludes REIT development of new properties.
2. Canadian REITs are all business trusts, not corporations. This means that Canadian REITs carry a risk (believed to be theoretical) of absence of limited liability protect and cannot use shares as currency for new property acquisition.
3. As a result of their recent introduction the Canadian securities environment, the Canadian financial market is not entirely familiar or comfortable with REITs.
4. The geography and demographics of Can make it less likely that Canadian REITs will specialize in a market niche and diversify geographically to the same degree as has been seen in the U.S.

Key Success Factors for Canadian and U.S. REITs:

A number of key success factors were identified for **all REIT categories in Canada**. These include:

1. a statement of clear strategic/asset class focus;
2. investment in superior quality assets in the relevant asset class;
3. strong management (preferably internal);
4. favorable past operating performance;
5. good projected cash flow growth prospects based on properties currently held;
6. access to capital on favorable terms;
7. sustainable distributions; and
8. attractive pricing.

In addition, a list of key success factors was identified for **all REITs operating in the U.S.** It is important to note that all of these factors are a function of overall size of the REIT, and will not be, by themselves, independent variables determining success. This list includes:

1. large market capitalization;
2. experienced and capable management;
3. geographic dispersion of risk;
4. access to high barrier to entry markets;
5. low debt levels;
6. quality of assets;
7. ability to use retained cash flow to generate internal growth; and
8. greater degrees of risk tolerance.

For **apartment REITs**, several additional criteria are necessary for a label of "Best-in-Class". These criteria were largely determined through the examination of the U.S. Apartment REIT industry because of the small sample size (2) in Canada. These include:

1. ownership of a large number of properties in geographically diverse areas with low vacancy rates;
2. high levels of capital expenditure that justify premium rental rates;
3. ownership of properties located in areas of high employment;
4. a focus on densely populated areas; and
5. the ability to purchase properties at below replacement cost, OR the ability to develop properties at a cost lower than would be possible using outside contractors.

Suggested Changes for Canadian Market: A list of suggested changes was identified and ranked. These options seek to address the limitations currently facing Canadian REITs, while simultaneously attempting to ensure the ability of Canadian REITs to satisfy the key success factors necessary for a designation of "Best-in-Class". The changes were identified, assessed and ranked individually in order of their potential ability to address the objectives set forth at the beginning of this summary. The individual changes are:

1. permitting REITs to adopt a corporate structure;
2. granting REITs limited liability protection;
3. permitting REITs to purchase properties in exchange for tax-deferred units;
4. changing the tax provisions;
5. clarifying that the term "Improvement" extends to development;
6. permitting REITs greater freedom in charging for additional services;
7. allowing Canadian REITs to have a larger share of foreign investment;
8. permitting joint ventures between U.S. REITs and Canadian REITs;
9. permitting joint ventures between U.S. REITs and Canadian institutional investors;
10. allowing U.S. REITs to operate independently in Canada;
11. providing an educational campaign for individual investors in regard to REITs;
12. creating a standard declaration of trust;
13. encouraging formation of a national body to promote the interests of REITs;
14. offering venture capital and mezzanine financing for new REITs;
15. providing guarantees for Canadian banks and other financial institutions for loans to REITs at more attractive lending rates;
16. creating a system of revenue guarantees for new construction; and
17. creating a system of rental subsidies.

In viewing the above policy suggestions, it is important to realize that some render others redundant. For example, granting REITs the right to organize as corporations eliminates the need to grant limited liability protection.

In considering these options, it is important to note certain limitations of REITs. In particular, although it is possible to implement options that will likely be successful in spurring growth in the Canadian apartment REIT industry, it must be remembered that REITs will have little incentive to offer housing that is affordable to lower-income Canadians unless options 16 and 17 are adopted.

Project Manager: Bruno Duhamel

Research Report: *Understanding the Relative Underdevelopment of REITs in Canada, 2002*

Research Consultant: David W. Conklin, Professor, Richard Ivey School of Business, The University of Western Ontario; Darroch A. Robertson, Professor, Richard Ivey School of Business, The University of Western Ontario; Darcy J.L. Jones, Research Associate, Richard Ivey School of Business, The University of Western Ontario;

Housing Research at CMHC

Under Part IX of the *National Housing Act*, the Government of Canada provides funds to CMHC to conduct research into the social, economic and technical aspects of housing and related fields, and to undertake the publishing and distribution of the results of this research.

This fact sheet is one of a series intended to inform you of the nature and scope of CMHC's research.

To find more *Research Highlights* plus a wide variety of information products, visit our Web site at

www.cmhc.ca

or contact:

Canada Mortgage and Housing Corporation
700 Montreal Road
Ottawa, Ontario
K1A 0P7

Phone: 1 800 668-2642
Fax: 1 800 245-9274

OUR WEB SITE ADDRESS: www.cmhc.ca

60975